MINDFUL ADVISORY, LLC

MARKET COMMENTARY & INVESTMENT INSIGHTS

Dear Investor,

> U.S. TIPS (Treasury Inflation Protected Securities) are among the most interesting investments currently.

I have written about TIPS before. But they have gotten cheaper, and, hopefully without being tedious and boring, I think it's worth explaining them in greater detail.

How TIPS Work

"Nominal" or normal bonds present an investor with inflation risk. They pay a fixed rate of return that can cause investors to suffer if inflation and higher interest rates exceed the rate the bond is paying. The yield on the bond doesn't change, which is why bonds are called "fixed income" or "fixed dollar assets," but the rate of inflation can change.

TIPS can remedy that problem. First issued by the U.S. Government in 1997, the principal of TIPS is tied to the Consumer Price Index or CPI. When CPI increases, so does the principal of a TIPS bond, which is said to undergo "accretion." Additionally, the coupon of the bond adjusts to the new principal.

It's important to note that a decline in CPI would cause the opposite effect on the bonds, lowering the principal and the interest payment. This is one of the risks of TIPS.

TIPS bonds, loans to the U.S. Treasury like their nominal cousins, can behave like their cousins despite their differences. Crucially, they can decline in price when rates move up. An investor who doesn't sell can see a "paper loss" at that point. This is another risk of TIPS. But an investor can gain the inflation benefit of the TIPS bond by not selling during those periods, and holding the bond to maturity.

Because TIPS bonds' prices fluctuate, they can present opportunities where they pay investors the tether to the CPI plus something extra. They can also trade in ways where they present something less than the tether to the CPI.

Currently, they are offering more than the tether to CPI if held to maturity.

The chart below shows the real yield (inflation plus or minus some yield depending on where the bond is trading) of a 10-year TIPS bond issued in 2020 and maturing in 2030. (The data to create the chart is from the St. Louis Fed website.)

When the line goes up, the real (inflation-adjusted) yield is up, and the bond is cheaper/more attractive.

You can see that until around May 2022, the bond was yielding something less than CPI, or it carried a negative real yield. After that, it began to yield something more than CPI, and now it yields right around 2% on top of its tether to CPI. Again, investors must understand they should achieve this return if they hold the bond until maturity.

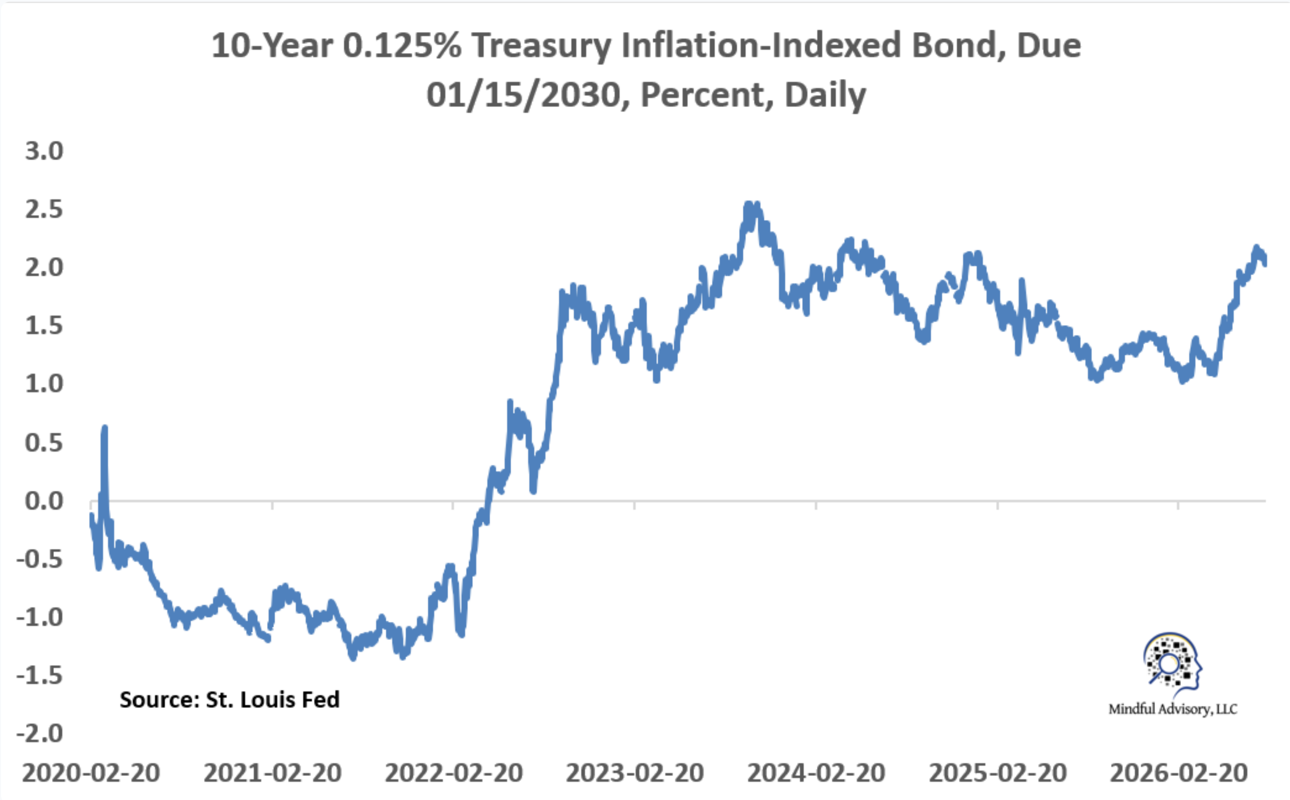

Chart note: *Past real yield performance is no guarantee of future returns. Yields shown reflect the 10-Year 0.125% Treasury Inflation-Indexed Bond due 01/15/2030 (Data Source: FRED, Federal Reserve Bank of St. Louis). Real yield fluctuates prior to maturity.*

TIPS with longer maturities are offering even more than this extra 2%.

Nothing says TIPS can't get cheaper still, and that one wouldn't be able to buy this bond with still a greater return or real yield for an investor holding it to maturity. But a 2% real yield above inflation for holding a medium-term bond to maturity represents a historically higher real return relative to the negative yield environment of 2020–2021.

Investors should note that Mindful Advisory's maximum fee is 0.75% per year, and that will lower the roughly 2% real yield to 1.25%. Fees also compound and reduce overall portfolio returns over time.

It is also important to note that TIPS lost money for investors in 2022 when inflation reached 9%. But that's partly because buying them early that year meant buying them with a negative real yield, as the bond in our example had.

TIPS also trade like nominal bonds before they mature, which means they tend to decline in price when interest rates go up. That's another reason TIPS generally declined in price in 2022.

That means that TIPS don't necessarily deliver inflation protection exactly at the time inflation is surging – another risk or characteristic investors should understand.

Now the situation is different than it was in early 2022, with the bond trading with a positive real yield of roughly 2%. But that still doesn't mean a surge in inflation before the bond matures will cause the bond to keep up at the moment inflation is surging. Holding to maturity is required. Selling prior to maturity in a rising interest rate environment may result in a loss of principal.

Your Wealth's Enemies: Taxes and Inflation

There are two things that erode wealth and purchasing power – taxes and inflation.

Nobody knows exactly if inflation is surging, but it may be useful to look at the 1970s when it did. Stocks did not do well then despite the ability of companies to raise prices. From 1970 through 1979, the S&P 500 delivered a 5.92% annualized return against an annualized inflation rate of 7.06%.

(We are using investment data from the NYU Stern School of Business for the stock market returns and data from the Minneapolis Fed for inflation returns.)

That means stocks delivered a negative "real" or inflation-adjusted return from 1970 through 1979.

It remains to be seen if the current war in the Middle East and elevated U.S. debt levels spur another such period.

The reason stocks don't always do well when inflation is particularly high is because while companies can pass higher costs on to consumers, their expenses also go up. More importantly, investors decide to downgrade stock prices relative to their earnings.

So when interest rates are low, and current yields are tepid on cash and bonds, stocks can trade at extravagant prices relative to their profits and cash flows. The opposite is also true. When inflation and rates are higher, investors tend to be willing to pay less for future profits of businesses, even with the assumption of pricing power.

Nominal bonds are just as bad in inflationary environments. They are loans to a government or company in return for an interest rate that is fixed or doesn't change. And that means inflation (and higher rates) erodes their value and the purchasing power of money invested in them. They have no possibility of increasing their payout to you the way the underlying businesses of stocks can increase their profits by raising prices on the goods and services they sell. Also, the longer a bond's maturity (the longer you're locked into a rate), the worse it performs during inflation.

Currently, the 10-year U.S. Treasury Note (a loan to the U.S. Government for the next decade) is currently paying the lender around 4.7%. That's beating the current year-over-year rate of inflation of 3.4%, but nobody knows if the rate of inflation will remain lower than the yield on the bond for the next decade. We do know the rate of return on the bond will not change, however. (Again, we are using the CPI or the Consumer Price Index for inflation.)

If you buy the bond, you are at risk of eroding your purchasing power if inflation rises above the bond's yield. Even if inflation stays where it is, the increase of your purchasing power in this investment is modest.

It's also possible we're in store for a deflationary episode, and nominal bonds will do well in "real" or inflation-adjusted terms with falling rates. But this letter will assume at least some inflation is the greater risk. The U.S., after all, is at debt levels compared to GDP not seen since the end of WWII.

Every investor has to weigh the probability that inflation is the greater risk. In the past, inflation has been more prevalent than deflation, though certainly periods of deflation have arisen, most notably in the Great Depression.

Risks

Besides the risk of deflation and interest rate risk prior to maturity, it is worth noting that U.S. debt levels are a cause of concern. But a default by the U.S. in the form of something like lower or missed interest payments might mean other parts of financial markets experience worse outcomes than the U.S. Treasury market. Nobody knows for sure though.

There is also the issue of whether CPI is an accurate measure of inflation. Some say it isn't. That may be true, but it would be difficult to find another security tied to a better measure of inflation with the credit quality of a U.S. Treasury Note or Bond.

Altogether, TIPS carry interest rate risk, deflation risk, risk of U.S. solvency, and whether CPI accurately measures inflation among others. All investors should consult with an advisor if considering purchasing TIPS.

Also, because of the fact that the price of TIPS undergoes accretion (change of principal) in its CPI tether, there is a kind of "phantom income" on which an investor is taxed, even though the investor doesn't realize that accretion as income. For this reason, TIPS are better held in tax-advantaged accounts such as IRAs.

Finally, there is one behavioral risk. Investors may not think 2% on top of inflation is very attractive. But if inflation runs at the levels it did during the 1970s, it might wind up being more attractive than it seems now.

Investors may be concentrating too much on the stellar returns that the S&P 500 has delivered since the end of the financial crisis. Students of market history know, however, that U.S. stock returns have been unusually high over that period. It may be harder to achieve 2% over inflation for the next decade than many think.

Our Dedication to Your Financial Plan: Don't Predict, But Be Prepared

We can't predict whether a 10-year TIPS bond will outperform the S&P 500 over the next decade, and the vast majority of investors shouldn't alter their allocations to stocks anyway. But since many investors hold bonds in their portfolios anyway to offset the volatility of stocks, TIPS present a positive real-yield alternative relative to recent years for investors evaluating fixed-income allocations and willing to hold bonds to maturity.

The point of sharing my thoughts on markets and financial planning is to provide some education and encourage investors to maintain diversified portfolios and consider a variety of strategies.

In an uncertain world, it is important to focus on what we can control: managing costs, maintaining a well-diversified portfolio aligned with your long-term goals and risk tolerance, and avoiding reactive decisions based on short-term market noise.

Please do not hesitate to contact me if you have any questions or if there have been any changes in your financial situation.

Respectfully submitted,

John Coumarianos

Mindful Advisory, LLC

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The mention of specific ETFs does not constitute a recommendation to buy, sell, or hold any security. Tickers listed are for illustrative/educational purposes regarding market access to TIPS.

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